Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:PHI:TL-N-6621-00
RHGannon

date: FEB 12 2001

to: Internal Revenue Service
601 Henderson Road,
Second Floor
King of Prussia, PA 19406
Attention: Wayne R. Aiken, E:1343

from: Associate Area Counsel (LMSB) - Philadelphia
Richard H. Gannon, Special Litigation Assistant

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subject: [redacted]
Request for Advice

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This memorandum is in response to your request for advice dated October 31, 2000.

FACTS:

[redacted] is engaged in the [redacted] business. Its [redacted] In the United States, virtually all orders are paid by credit card.

In [redacted]'s. [redacted] began expanding its business to foreign countries, first to [redacted] and [redacted] and then, in [redacted] to [redacted]. Unlike its first two foreign ventures, the [redacted] venture, in the form of a [redacted] or partnership, was owned [redacted]% by one domestic subsidiary and [redacted]% by the other. The

[redacted] partnership, [redacted] ("[redacted] partnership") was licensed to [redacted] only in the state of [redacted], although [redacted]. According to the taxpayer, there was no written agreement between it and the [redacted] partnership.

Most of the start up costs incurred by the [redacted] partnership were paid to unrelated parties for work performed, facilities provided or for [redacted] fees. Some costs were incurred in connection with work performed by either the taxpayer or its [redacted] affiliate.[1]

On its [redacted] return, the taxpayer filed an election pursuant to I.R.C. § 1057 stating that it transferred "certain intellectual property" to the [redacted] partnership, and that both the adjusted basis in the property transferred and its value was zero. The effect of the election was to treat the transfer as a sale or exchange of property and to avoid the imposition of the excise tax then provided by I.R.C. § 1491.[2] The question posed is whether there is any basis for concluding that property was transferred to the [redacted] partnership. If its is concluded that property was transferred, the second question is how the property in question is to be valued.

DISCUSSION:

While certain intangibles such as technical know-how, secret processes and formulas, and other items of a similar character can qualify as property, the question of whether these items have been "transferred" requires something more than a mere license to use the intangibles. Ordinarily, such a transfer qualifies as such only where the exclusive right to use the intangibles in the foreign country in question is transferred to a third party, related or unrelated. Rev. Rul. 64-56, 1964-1 CB 133.

In this case, the taxpayer states that there was no written contract between it and the [redacted] partnership. In the absence of such a contract, it is difficult, if not impossible to conclude that the intangibles made available to the [redacted] partnership were made available on an exclusive basis. Moreover, the fact that the [redacted] partnership owned the [redacted] rights only in the [redacted] gave it no such rights in the other [redacted] states. Nothing indicates that it was

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[1] According to the taxpayer, these costs amounted to $[redacted].

[2] I.R.C. § 1491 was repealed by § 1131(a) of the Taxpayer Relief Act of 1997, PL 105-34 (111 Stat. 983 (1997).

impossible for the intangibles made available to the [redacted] partnership to also be made available to another party in another [redacted] state or to be used by the taxpayer itself. This fact, in and of itself defeats the transaction's characterization as a "transfer of property." See Rev. Rul. 64-56, supra, Rev. Rul. 69-156, 1969-1 CB 101.

Of course, where a taxpayer makes know-how available to a related party, the fact that there is no "transfer" of the know-how in a technical sense does not eliminate the possibility of any federal income tax consequences. For example, if no payment is made for the use of the intangibles, the provisions of I.R.C. § 482 may be called into play, in some cases justifying an allocation of income from one related party to another to prevent the evasion of tax or to clearly reflect income.

On the face of it, there appears to be little potential for a § 482 adjustment here. As noted by the taxpayer, [redacted] in [redacted] are in [redacted] items that are popular in [redacted] are not necessarily popular here, and the operation of a [redacted] appears relatively transparent, requiring little in the way of secret know-how. Moreover, there appears to be little potential for an adjustment under § 482 on the grounds that the taxpayer performed services for the [redacted] partnership without proper compensation. As noted above, the [redacted] partnership incurred costs of over $[redacted] for services provided by the taxpayer and its [redacted] affiliate. We assume that these charges were actually paid by the [redacted] partnership and that the charges in question represent all of the costs incurred by the taxpayer and the [redacted] affiliate in performing the services in question.

On the basis of the foregoing, there appears to be no grounds for asserting that the taxpayer realized any gain on the transfer of intangible property to the [redacted] partnership, both because there was no "transfer" for federal income tax purposes and because it is difficult to see how the minimal know-how transferred had any cognizable value. In this regard, the taxpayer's § 1057 election appears, as taxpayer claims, merely a protective matter designed to shield the taxpayer from the remote possibility that an excise tax might be imposed under former § 1491.

CONCLUSION:

This concludes our advice in this matter. We are forwarding a copy of this memorandum to the Senior Litigation Counsel (HQ) (CC:LM:MTC:SLC) for mandatory ten day post review. Please refrain from taking any final action in this matter for a period of 15 days in case we receive contrary advice from our national office.

Please contact the undersigned at 215-597-8547 if you have any questions or comments regarding this memorandum.

RICHARD H. GANNON
Special Litigation Assistant

APPROVED:

JAMES C. FEE, JR.
Associate Area Counsel (LMSB)

cc: Harve Lewis (CC:LM:MTC:SLC)

[redacted]:

[redacted]